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No. 06-659

IN THE

Supreme Court of the United States

COLTEC INDUSTRIES INC.,

Petitioner,

v.

UNITED STATES,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

REPLY BRIEF

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RULE 29.6 STATEMENT

The Rule 29.6 statement in the petition is current.

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REPLY BRIEF

Petitioner Coltec Industries Inc. ("Coltec") demonstrated in the petition for certiorari that there is a 5-3 split in the courts of appeals concerning the standard of review for determinations that a transaction lacks economic substance, and a 2-3-3 split over the substantive standard governing such determinations. Coltec further showed that the Federal Circuit's decision on those issues, and its definition of the relevant transaction to be tested for economic substance, are contrary to the decisions of this Court. The Government does not deny the circuit conflicts. Instead, intent upon preserving a powerful extrastatutory weapon in litigation against taxpayers, the Government offers only gossamer arguments that the standard-of-review issue was not preserved below, and that the conflicting substantive standards are of no importance in the administration of the revenue laws. The first question regarding the standard of review unequivocally was both passed on *and* presented below. On the second question, the Government's position is belied by the acknowledgement of the IRS Chief Counsel (and leading tax commenters) that the substantive law of economic substance is in disarray and that the three-way circuit conflict can only be resolved by this Court. Moreover, the IRS has trumpeted its intent to use the Federal Circuit's decision aggressively in tax litigation. The conflicting standards announced by the courts of appeals, and especially the decision below, have created extraordinary uncertainty in tax planning, and this Court should grant review to resolve the conflicts and to clarify what common-law powers federal courts possess to deny taxpayers benefits to which the terms of the Internal Revenue Code entitle them.

1. The Government acknowledges the 5-3 conflict over the standard of review, noting that "several courts of appeals have stated that a district court's determination as to whether a transaction had economic substance was reviewable only for clear error." Opp. 12. Nonetheless, the Government attempts

to cloud the issue by claiming, without citation, that "it is unclear whether the courts were deferring to the ultimate determination on economic substance, or merely to underlying factual determinations that may have been dispositive of that ultimate determination." *Id.* The Government is wrong. A number of decisions explain in depth why they reject *de novo* review even for "ultimate" economic substance determinations. Pet. 14-15 (discussing analysis in *Rexnord, Inc.* v. *United States*, 940 F.2d 1094, 1096 (7th Cir. 1991)).[1]

2. The Government grasps at straw in arguing (Opp. 12-13) that the standard-of-review issue is not preserved. This Court will review any question that was *either* passed on *or* presented below. *United States* v. *Wells*, 519 U.S. 482, 488 (1997) (waiver rules applicable to lower federal courts do not govern this Court). The Government concedes (Opp. 10) that the Federal Circuit passed on the standard of review, holding that "[t]he ultimate conclusion as to business purpose is a legal conclusion, which we review without deference." Pet.

[1] Additionally, the Third Circuit, citing a line of authority tracing back to *Pullman-Standard* v. *Swint*, 456 U.S. 273, 285-90 (1982), adopted the clear-error standard for tax cases and disclaimed its earlier practice of applying *de novo* review to "ultimate facts," *see Pleasant Summit Land Corp.* v. *Commissioner*, 863 F.2d 263, 268 (3d Cir. 1988), including economic substance determinations, *see ACM P'ship* v. *Commissioner*, 157 F.3d 231, 245 & n.25 (3d Cir. 1998). The court reasoned that it was improper to "'divide findings of fact into those that deal with "ultimate" and those that deal with "subsidiary" facts.'" *American Home Prods. Corp.* v. *Barr Labs., Inc.*, 834 F.2d 368, 370 n.2 (3d Cir. 1987). Contrary to the Government's claim, Opp. 12, both the D.C. and Seventh Circuits have made it clear that even ultimate findings of economic substance that involve application of law to fact are reviewed for clear error. *ASA Investerings P'ship* v. *Commissioner*, 201 F.3d 505, 511 (D.C. Cir. 2000) ("Factual findings are reviewed for clear error, and determinations of law de novo. We have held that in tax cases mixed questions of law and fact are to be treated like questions of fact.") (citations omitted); *Yosha* v. *Commissioner*, 861 F.2d 494, 499 (7th Cir. 1988) ("The question whether a particular transaction has economic substance, like other questions concerning the application of a legal standard to transactions or events, is governed by the clearly erroneous standard.").

App. 28a. Th e question of whether or not Coltec properly "preserved" th e issue before the Federal Circuit is therefore irrelevant.

Moreover, th he Government's waiver argument is contrived. It acknowledge es that Coltec argued to the Federal Circuit that "'the Court of Federal Claims' factual determinations may be disturbed only if they were clearly erroneous.'" Opp. 13 (quoting Pet. C .A. Br. 33 n.18) (alterations omitted). But the Government c ontends that by referring to "factual" determinations, Coltec "argued, at most, that the trial court's *underlying* factual find lings were reviewable only for clear error – and never suggeste d that the trial court's *ultimate* determination was also subj ect to clear-error review." *Id.* The Government's reasoni ing is baseless. Coltec never drew any distinction between ultimate and subsidiary facts or suggested that clear-error revi iew should be limited to the latter. As a general rule, all findin gs of fact after a bench trial are subject to clear-error review, F ed. R. Civ. P. 52(a) ("Findings of fact ... shall not be set aside unless clearly erroneous"), including findings of ultimate facts. *Bose Corp.* v. *Consumers Union of U.S., Inc.*, 466 U.S. 485, 501 (1984) ("Rule 52(a) applies to findings of fact, including those described as 'ultimate facts' because they may determine the outcome of litigation ...."); *Pullman-Standard* v. *Swint*, 456 U.S. 273, 287 (1982) (clear error review not limited to subsidiary facts); *League of United Latin Am. Citizens* v. *Perry*, 126 S. Ct. 2594, 2614 (2006) ("'ultimate finding'" of vote dilution reviewed for clear error). Coltec's consistent position throughout this case is that all factual findings of the Court of Federal Claims ("CFC") after bench trial – including the ultimate facts of business purpose and economic substance – are reviewable only for clear error.

Indeed, the Government inexplicably fails to disclose that Coltec repeatedly argued that very point in its Federal Circuit brief. The CFC found the economic substance doctrine satisfied by incorporating by reference its findings under the anti-

abuse test of section 357(b) of the Internal Revenue Code: "the court already has considered and held that Coltec satisfied the tax avoidance and business purpose tests in Section 357(b), therefore, *ipso facto*, the 'economic substance' doctrine is satisfied, since that doctrine requires proof of at least one of these tests." Pet. App. 115a. In its brief to the Federal Circuit, in addition to the statement of the clear-error standard quoted above, Coltec argued that "the CFC found as a matter of fact that the section 357(b) test was satisfied in this case. That fact finding is amply supported by the record, and the government falls far short of establishing that it was clearly erroneous." Reply App. 1a. Regarding the economic substance doctrine, Coltec reiterated that "the government has not demonstrated that those findings were clearly wrong – and they were not." Reply App. 2a.[2] Coltec's Federal Circuit brief could not have been clearer that a clear-error standard should be applied to all CFC findings of business purpose and economic substance (ultimate and subsidiary), and it certainly never invited the Federal Circuit to decide these questions *de novo*. The Government's waiver argument is neither relevant nor credible.[3]

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[2] *See also, e.g.*, Reply App. 3a ("the government's second-guessing of the business judgments of the decision-makers, as found by the CFC, is no substitute for proof that the court's findings were clearly erroneous"); *id.* ("[t]he CFC determined that the record established, by a clear preponderance of the evidence, that Garrison's assumption of Garlock's contingent asbestos liabilities had a bona fide business purpose that satisfied section 357(b)," and "[t]he record fully supports the CFC's finding, and the government's bald assertions to the contrary fall well short of demonstrating clear error"); *id.* ("[f]or these reasons, whether viewed as economic substance or business purpose arguments, the government's 'economic substance' challenges to the CFC's findings are meritless"); *id.* ("the CFC's findings relating to business purpose and economic substance are unassailable").

[3] The Government does not honor even the CFC's subsidiary findings; its characterization of the facts (which restates its trial position) was rejected by the CFC. Pet. App. 35a. Coltec's asbestos-related losses were not "artificial," Opp. 2; they were real economic losses arising from the taxpayer's historic business, just like the losses allowed in *Cottage Sav-*

3. Abandoning its prior position that clear error is the proper standard,[4] the Government now defends the Federal Circuit's adoption of a *de novo* standard as consistent with *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978). This is an issue for the merits stage, but the Government ignores that *Frank Lyon* applied the *de novo* standard to the proper characterization of a transaction under the tax code, where the facts were undisputed, *id.* at 563, not to the question whether a transaction may be disregarded altogether as a sham. *Frank Lyon* held only that "the general characterization of a transaction for tax purposes" (there, whether there was a "sale" giving the purchaser the right to depreciation deductions) is a question of law subject to *de novo* review, but findings of fact are not. *Id.* at 581 n.16. Indeed, in stating that standard, *Frank Lyon* relied on a case holding that the ultimate conclusion on the economic substance of a transaction was a fact issue for the jury (whereas the taxpayer's right to claim depreciation was a question of law). *Id.* (citing *American Realty Trust* v. *United States*, 498 F.2d 1194, 1197-99 (4th Cir. 1974)). Similarly, in *Knetsch* v. *United States*, this Court distinguished the trial judge's "findings" regarding economic substance from the "conclusion of law," derived from those findings, that the payments at issue were not, in substance, "interest paid ... on indebtedness" within the meaning of the Code. 364 U.S. 361, 362, 364 (1960) (omission in original).

The Federal Circuit's *de novo* standard conflicts with this Court's precedents, Pet. 16-17, but even if *arguendo* the Gov-

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ings Association v. *Commissioner*, 499 U.S. 554, 555 (1991). Moreover, despite the Government's intimation to the contrary (Opp. 4), this Court has repeatedly stated that different treatment of a transaction in tax and financial accounting is irrelevant. *E.g.*, *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 542 (1979) (financial accounting is designed to provide "useful information to management" and other parties, whereas tax accounting concerns the "equitable collection of revenue").

[4] *E.g.*, *American Elec. Power Co.* v. *United States*, 326 F.3d 737, 741 (6th Cir. 2003); *Rexnord, Inc.* v. *United States*, 940 F.2d 1094, 1096 (7th Cir. 1991).

ernment were right that the decisions of the five clear-error circuits "cannot be reconciled with" *Frank Lyon*, Opp. 12, that is a reason to grant the petition, not to deny it.

4. Finally, led astray by its position that any "ultimate" determination is a question of law, the Government claims that the Federal Circuit's decision involved only legal issues. *Id.* at 14. That is untrue. Even under a strictly objective test, issues of whether a transaction has economic substance because it "'appreciably affect[s the taxpayer's] beneficial interest'" other than tax avoidance, *Knetsch*, 364 U.S. at 366, are quintessentially factual, in this and any other case. Here, the CFC made findings on (inter alia) the business purpose of isolating asbestos liabilities, the probable effect of the adequate capitalization of the Garrison subsidiary in deterring plaintiffs from bringing or courts from granting veil-piercing claims, and the effect on the investment community and a potential acquirer of Coltec's isolation of asbestos liabilities in Garrison. Pet. 10-11, 25-27; Pet. App. 79a-91a, 116a. For example, the CFC found that "the Garrison transaction not only appeared to place one more barrier in the way of veil piercing claims, but it provided the B.F. Goodrich Corporation with a sufficient comfort level to purchase all of the Coltec Group in 1999." Pet. App. 116a. In keeping with *Frank Lyon*, this CFC finding of the ultimate fact of economic substance after a bench trial deserved deference.

5. The Government fares no better in its arguments regarding the 2-3-3 circuit conflict over the substantive standard for determining when a transaction has economic substance. The Government again acknowledges that the announced rules conflict, Opp. 15-18, but claims (in the last redoubt of every opponent of certiorari) that the conflicting rules may not "differ[] in any meaningful way" in their application. *Id.* at 18.

The Government is wrong. A circuit conflict does not depend on the happenstance of what facts were presented to a circuit in a given case: the issue is whether the circuits would apply a different rule to the *same* set of facts. Here, there is

no question that the Fourth and D.C. Circuits have announced a distinct rule (not dictum) that the test for economic substance is conjunctive: a transaction may not be disregarded unless "the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, *and* ... the transaction has no economic substance because no reasonable possibility of a profit exists." *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985) (emphasis added); *Black & Decker Corp.* v. *United States*, 436 F.3d 431, 441 (4th Cir. 2006) (noting that "subjective" purpose in the first prong must be supported by more than mere assertions of belief); *Horn* v. *Commissioner*, 968 F.2d 1229, 1238 (D.C. Cir. 1992); Pet. 19-20. The Fourth Circuit has consistently required proof on both the subjective and objective prongs. *E.g.*, *Hunt* v. *Commissioner*, 938 F.2d 466, 471-72 (4th Cir. 1991); *Friedman* v. *Commissioner*, 869 F.2d 785, 792-93 (4th Cir. 1989). Indeed, in *Black & Decker*, the Fourth Circuit, in remanding to the district court, instructed that "the trial to resolve whether Taxpayer's transaction was a sham *must determine whether both prongs* of the *Rice's Toyota* test are satisfied." 436 F.3d at 442-43 (emphasis added).[5] The Fourth Circuit's substantive standard, as applied and not just as stated, is in direct conflict with the Federal Circuit's rule, where subjective business purpose is irrelevant except as evidence probative of objective substance, Pet. App. 31a. Indeed, the Federal Circuit acknowledged the conflict. *Id.* at 24a n.14. Coltec would have prevailed under the Fourth and D.C. Circuit tests.[6]

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[5] The Government vaguely states that *Black & Decker*, like the decision below, "reversed the trial court's determination" of economic substance. Opp. 10. To clarify, the Fourth Circuit held that summary judgment was improper because there was a genuine issue of fact as to both subjective purpose and objective substance; it did not override the trial court's findings after a bench trial. *Black & Decker*, 436 F.3d at 442-43.

[6] The Government states (Opp. 19) that the D.C. Circuit did not apply the conjunctive test of *Horn* v. *Commissioner*, 968 F.2d at 1238, in *ASA Investerings Partnership* v. *Commissioner*, 201 F.3d 505 (D.C. Cir. 2000).

The Federal Circuit rule is also in conflict with those jurisdictions that apply a "unitary standard" mandating findings of *objective* economic substance and *subjective* business purpose, and a balancing of the two. Pet. 21-22. Once again these are conflicting rules; these courts do not (like the Federal, Sixth, and Eleventh Circuits) end the inquiry merely upon a finding of lack of objective economic substance, nor do they treat subjective purpose as merely probative evidence. *Id.* at 22.[7] Contrary to the Government's claim, Coltec does not "concede[]" that "it is at best questionable whether petitioner" would prevail under a unitary standard. Opp. 17. Coltec should have prevailed under the Federal Circuit's strictly objective standard, and even more easily under a unitary standard (given the strong evidence of both objective economic substance and the bona fide subjective business judgments of experienced business executives). Pet. 21-27.

ASA involved the separate (although related) inquiry of whether a partnership is a sham entity under the two-part test of *Moline Properties* v. *Commissioner*, 319 U.S. 436 (1943). The first prong of the *Moline* test looks to whether the partnership carried on any "business activity" (was it a "sham-in-fact") and the second prong to "business purpose" (which in that context is essentially the "economic substance" test). *ASA*, 201 F.3d at 512. Under that prong, the *ASA* court looked to both objective and subjective evidence, *id.* at 512-13, but the ultimate inquiry was subjective: "whether, all facts considered, the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance." *Id.* at 513. The Court ruled for the IRS because it found no such intent. *Id.* at 516. *ASA* in no way detracts from *Horn*; if anything, it underscores the necessity to find the absence of subjective business purpose.

[7] *See, e.g.*, *Shriver* v. *Commissioner*, 899 F.2d 724, 726 (8th Cir. 1990) (addressing the taxpayer's argument that the transaction had a business purpose even though the taxpayer did not dispute the objective finding of lack of economic substance). Many cases applying the unitary standard give separate consideration to the objective and subjective elements of the test. *See, e.g., In Re CM Holdings, Inc.*, 301 F.3d 96, 105-06 (3d Cir. 2002); *Casebeer* v. *Commissioner*, 909 F.2d 1360, 1363-64 (9th Cir. 1990); *IES Indus., Inc.* v. *United States*, 253 F.3d 350, 354-56 (8th Cir. 2001); *Compaq Computer Corp.* v. *Commissioner*, 277 F.3d 778, 784, 786-87 (5th Cir. 2001).

But at a minimum, Coltec would be entitled to a new determination under a unitary standard, underscoring that the rules are in conflict and this Court should grant review. This Court should look past the Government's litigation posture in this case, and heed the opinion of the IRS chief counsel that there is an entrenched conflict in the circuits that can only be resolved by this Court's intervention. *Korb Acknowledges U.S. Supreme Court May Need To Clarify Economic Substance Doctrine*, Daily Tax Rep. (BNA) (Oct. 27, 2006); Donald L. Korb, *Korb Gives Speech on Economic Substance Doctrine* (Jan. 25, 2005), *available at* 2005 TNT 16-22 (LEXIS).

6. The Government dismisses the prospective importance of this case because Congress has amended the statute governing contingent-liability transactions. Opp. 20. The issue of prospective importance is not the particular statutory provisions, but the common-law power of courts to disqualify transactions *regardless* of the Code provision at issue (which potentially affects every transaction undertaken by taxpayers). Indeed, the irrelevance of the statutory questions decided by the courts below makes this case an especially attractive one to decide solely the economic-substance question presented.[8]

The significance of the Federal Circuit's economic substance ruling cannot be overstated. The IRS has heralded the decision below as a case that will be of "wide use" in its enforcement efforts, and the Tax Division has filed 143 cases in which the doctrine will be invoked, "with trial teams already assembling for 85 of those cases." A. Bennett, *Tax Shelters: Government Still Confident On Shelters Even As Taxpayers Fight Appeals Losses*, Daily Tax Report (BNA) (Oct. 23, 2006); S. Stratton, *Korb Praises, Practitioners Question En-*

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[8] It is doubtful that the Government would raise its strained statutory arguments, which no court has accepted, Pet. App. 17a, as alternative grounds in support of the judgment. But even if it did, *see* Opp. 20 n.6, this Court always has discretion to answer only the question presented and not to reach such alternative grounds. *United States* v. *Nobles*, 422 U.S. 225, 241 n.16 (1975).

forcement Shift, 113 Tax Notes 394 (Oct. 30, 2006) (noting Korb's belief that "the principles from [the *Coltec* case, among others,] will be cited 20 years from now"); *see also* J. Carreyrou & J. Drucker, *Merck Tax Disputes Could Cost It Up To $5.58 Billion*, Wall St. J., Nov. 8, 2006, at A3. The number of filed cases is a small fraction of the audits that the IRS conducts (and the settlements it extracts) under the auspices of the economic substance doctrine across a broad array of transactions. See K. Ritterpusch, *Government Armed With New Tools, Settlement Models In Fight Against Shelters*, Daily Tax Report (BNA) (Jan. 5, 2005). Moreover, as *amici curiae* point out, the law protects good-faith subjective business judgments to eliminate undue litigation risks that chill legitimate activity; those risks are heightened by the strictly objective test (and *de novo* standard of review) established below. Br. of National Association of Manufacturers and U.S. Chamber of Commerce 3-9.[9] Finally, the Government does not dispute that the Federal Circuit's holding on the relevant transaction to be tested for economic substance, where even the tax-advantaged step of a multi-step, integrated transaction must be shown to have business purpose, injects extraordinary and deleterious uncertainty into tax planning (or that this holding is at odds with precedents of this Court and other circuits). Pet. 30. Clarity of rules in this area of the tax law is vital, and this Court's immediate review is imperative.

CONCLUSION

The petition for a writ of certiorari should be granted.[10]

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[9] The CFC credited the testimony of Coltec's CEO that he would have approved the liability-shifting transaction for non-tax business reasons even if no tax benefits were available. Pet. 6; Pet. App. 45a, 80a.

[10] Because of the importance of this issue, the Court may wish to consider this petition for the April, 2007 sitting.

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

No. 05-5111

[filed Sept. 6, 2005]

COLTEC INDUSTRIES, INC.

Plaintiff-Appellee,

v.

UNITED STATES,

Defendant-Appellant.

BRIEF FOR PLAINTIFF-APPELLEE COLTEC INDUSTRIES, INC.

* * * *

[22] The CFC properly rejected the government's effort to avoid this result by invoking section 357(b). By its terms, that section is relevant to gain recognition, not basis determination. Indeed, in the audit in this case, the IRS's own corporate tax experts concluded that section 357(b) could not be used to reduce Garlock's basis in its Garrison stock. Lastly, the CFC found as a matter of fact that the section 357(b) test was satisfied in this case. That fact finding is amply supported by the record, and the government falls far short of establishing that it was clearly erroneous. The CFC also correctly held that the "deductible-when-paid" exclusion was applicable. The government's argument that the statute contains an unstated qualification is contrary to the plain words of the Code and has no support.

Similarly fallacious is the government's alternative argument that an assumption of contingent liabilities is "property" under section 358(a). The government's theory would render section 358(h) superfluous.

The government's economic substance argument is equally ill-founded. That doctrine concerns transactions that were done solely to generate a tax benefit and that have no economic reality whatsoever. It has no application here. Objectively, the Garrison transaction had incontrovertible economic substance, involving among other things the transfer of substantial assets; the assumption of [23] real liabilities; the creation of a company with employees, substantial activities, and outside shareholders; and the investment of half a million dollars by those shareholders. All those changes were permanent and remain in place today. Subjectively, the CFC found that a number of bona fide business purposes motivated the participants and that tax benefits were not the main reason for the transaction. Again, the government has not demonstrated that those findings were clearly wrong – and they were not.

* * * *

[33] The government also asserts that Coltec's concern about veil-piercing "has no connection to Garrison's assumption of Garlock's liabilities." (Brief at 57) After hearing the evidence, however, the CFC found that the asbestos liabilities were assumed because management believed the assumption would help against veil-piercing claims and would make Coltec more marketable. That finding as to intent can be set aside only if clearly erroneous, which the government cannot demonstrate.[18]

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[18] The CFC's factual determinations may be disturbed only if they were clearly erroneous. *See Landmark Land Co. v. FDIC*, 256 F.3d 1365,1373 (Fed. Cir. 2001) ("We afford the trial court's findings of fact 'considerable deference,' disturbing them only if they are shown to have been 'clearly erroneous.'") (citation omitted).

* * * *

[34] ... The government's assertion that the CFC's determinations were "groundless" (Brief at 49) is wrong. In any event, the government's second-guessing of the business judgments of the decision-makers, as found by the CFC, is no substitute for proof that the court's findings were clearly erroneous. *Cf. Jacobson v. Commissioner*, 915 F.2d 832, 838-39 (2d Cir. 1990) (a court should not ignore the evidence that the decision to invest was made by informed decision-makers and make its own prediction as to whether the investment was likely to be profitable.)

* * * *

[36] The CFC determined that the record established, by a clear preponderance of the evidence, that Garrison's assumption of Garlock's contingent asbestos liabilities had a bona fide business purpose that satisfied section 357(b). (JA38) The record fully supports the CFC's finding, and the government's bald assertions to the contrary fall well short of demonstrating clear error.

* * * *

[52] For these reasons, whether viewed as economic substance or business purpose arguments, the government's "economic substance" challenges to the CFC's findings are meritless.

* * * *

[56] As demonstrated above, the CFC's findings relating to business purpose and economic substance are unassailable.

* * * *